| Bath & North East Somerset Council | |
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| MEETING: | **AVON PENSION FUND COMMITTEE** |
| MEETING DATE: | **25 SEPTEMBER 2020** |
| TITLE: | **INVESTMENT PERFORMANCE AND STRATEGY MONITORING (for periods ending 30 June 2020)** |
| WARD: | **ALL** |
| **AN OPEN PUBLIC ITEM** | |
| **List of attachments to this report:**<br>Appendix 1 – Fund Valuation<br>Appendix 2 – Mercer Annual Investment Review<br>Appendix 3 – LAPFF Quarterly Engagement Monitoring Report | |

## 1 THE ISSUE

1.1 This paper reports on the investment performance of the Fund and seeks to update the Committee on routine strategic aspects of the Fund's investments and funding level; and policy and operational aspects of the Fund.

1.2 This report contains performance statistics for periods ending 30 June 2020.

## 2 RECOMMENDATION

**The Avon Pension Fund Committee is asked to note:**

2.1 **The information set out in the report and appendices**

## 3 FINANCIAL IMPLICATIONS

3.1 The returns achieved by the Fund from 1 April 2020 will affect the 2022 triennial valuation. Section 4 of this report discusses the trends in the Fund's liabilities and the funding level.

## 4 FUNDING LEVEL

4.1 Using information provided by the Actuary, Mercer has analysed the funding position as part of the report at Appendix 2 (section 2). This analysis shows the impact of both the assets and liabilities on the (estimated) funding level. **It should be noted that this is just a snapshot of the funding level at a particular point in time.**

4.2 Key points from the analysis are:

a) The funding level increased from 84% to 92% over the quarter to 30 June 2020. Based on investment returns and net cashflows into the Fund, the deficit was estimated to have recovered over 2Q20, from £864m to £420m.

b) The increase in the funding level occurred as the value of the assets rose by more than the present value of the liabilities over the period.

## 5 INVESTMENT PERFORMANCE

### A – Fund Performance

5.1 The Fund's assets increased by £489m (c.10.9%) over the quarter ending 30 June 2020 giving a value for the Fund of £4,955m. Appendix 1 provides a breakdown of the Fund valuation and allocation of monies by asset class and manager. Manager performance is monitored in detail by the Investment Panel. The Fund's investment return and performance relative to the benchmark is summarised below. The Fund's currency hedge detracted -0.1% over the quarter.

**Table 1: Fund Investment Returns** (Periods to 30 June 2020)

| | 3 Months | 12 Months | 3 Years (p.a) |
|---|---|---|---|
| Avon Pension Fund (incl. currency hedging) | 8.6% | -0.9% | 3.5% |
| Avon Pension Fund (excl. currency hedging) | 8.7% | -0.5% | 3.9% |
| Strategic benchmark (no currency hedging) | 9.1% | -0.3% | 4.3% |
| Currency hedge impact | -0.1% | -0.4% | -0.4% |

5.2 **Fund Investment Return:** The second quarter of this year saw a strong rebound in markets. Risk assets, with the exception of property, performed strongly as a whole and defensive assets delivered low single digit returns, Sterling weakened marginally over the quarter against the US Dollar, Yen and Euro. Further information on asset class performance can be found on page 8 of Appendix 2.

5.3 **Fund Performance, exclusive of currency hedging and LDI, was 7.7% over the quarter versus a benchmark return of 8.7% on the same basis. The relative -1.0% over the quarter is attributed to;**

a) **Asset Allocation (excluding equity protection):** Asset allocation contributed +**0.4%** over the quarter, driven mainly by an overweight to developed market equities versus the strategic benchmark.

b) **Manager Performance:** Active manager impact over the quarter was +**0.3%.** Lead contributors included the Fund's overseas equities allocation and multi asset credit. Conversely, the lead detractors were the property mandates.

c) The equity protection strategy declined in value by £106m, (-1.7%) which drove underperformance versus the benchmark.

5.4 **Currency Hedging:** The hedging programme is in place to manage the volatility arising from overseas currency exposure, in particular to protect the Fund as sterling strengthens and returns from foreign denominated assets reduce in sterling terms. The hedging programme detracted 0.1% over the quarter.

5.5 **Liability Risk Management Strategy Performance:** The liability risk management strategy seeks to 'lock in' to attractive levels of real interest rates to achieve increased long-term certainty of real returns. Any increase in the present value of the Fund's liabilities should be met with a subsequent increase in the value of the liability hedging component of the BlackRock Qualifying Investor Fund (QIF). Over the quarter, and in line with expectation, the liability hedge posted positive returns as inflation rose, which was offset by an equivalent rise in the liabilities. The Liability Benchmark Portfolio (LBP) was updated based on the assumptions and member data underlying the 2019 actuarial valuation. Information pertaining to the Investment Panel's annual review and proposed changes to the liability risk management strategy can be found at Item 12: Annual Review of Risk Management Strategies.

5.6 **Equity Protection Strategy Performance (EPS):** The EPS performed as expected over the quarter. As markets recovered from the lows seen in the previous quarter the positive value attached to the EPS decreased as equity markets moved toward the upside cap(s). Tranche 3 of the EPS exhibited negative market value at quarter end as all underlying equity markets, except for the UK, had recovered to a point beyond the upside cap struck when the tranche was extended in March 2020. Since inception (November 2017) the overall return of the proxy equity portfolio, net of the protection, was c. 8.8% for developed market equities. If the protection had not been in place the return would have been c.11.5%. The net return, since inception (January 2020), for the emerging market portion was -4.1%. If the protection had not been in place the Fund would have incurred losses of c. -7.0%. Information relating to strategic developments in the EPS are also covered in Item 12.

5.7 **Collateral Management:** The collateral early warning trigger was breached during the quarter in respect of equity market increases and inflation falls, however no action to top up collateral was taken. Under the mandate guidelines the manager has ultimate discretion to sell down passive equities held in the QIF to replenish collateral and replace any lost equity exposure synthetically. The manager will endeavour to consult Officers and Mercer before action is taken. Post period-end equity markets continued to rally depressing the value of the collateral. Officers are working with the manager and Mercer to establish whether a portion of the passive equities need to be synthesised.

**B – Investment Manager Performance**

5.8 Under the Red Amber Green (RAG) framework for monitoring manager performance, the Panel consider updates on all managers not currently achieving Green status including progress on action points. Any change in the

RAG status of any manager is reported to Committee with an explanation of the change. **There were no changes to manager ratings this quarter.**

5.9 Manager total returns over the quarter were positive for all assets, with the exception of the property mandates. Equities in particular performed strongly due to co-ordinated central bank action designed to limit the economic fallout of the pandemic. The Fund's DGF, Multi-Asset Credit and Fund of Hedge Funds strategies also performed well. Over the year, returns were mixed as some managers were not able to recover all of the losses incurred earlier in the year. Of the mandates with a 3-year track record most outperformed their respective benchmarks and performance targets, with property mandates again the exception. Detailed analysis of investment manager performance can be found at Appendix 2.

5.10 With Brunel now managing most of the liquid assets, officers and Mercer will revise the quarterly monitoring reports to reflect the new arrangements.

## 6 INVESTMENT STRATEGY

6.1 **Asset Class Returns:** Developed market equity returns over the last 3 years were 8.8% p.a., ahead of the assumed strategic return of 8.1% p.a. on the same basis. The 3-year return from emerging market equities was 4.6%; below the assumed 3-year return of 8.7%. Over the 3-year period index-linked gilts returned 7.6% p.a. versus an assumed return of 2.2%. The 3-year UK property return of 3.9% p.a. lags its assumed return of 5.75%, due to continued recent uncertainty.

6.2 **Private Markets Commitments to Brunel Portfolios:** At 30 June 2020 34% of the Fund's cycle 1 £115m commitment to Brunel's renewable infrastructure portfolio had been deployed and 32% of the Fund's £345m commitment to the secured income portfolio had been deployed. The pace of capital deployment across both asset classes has slowed due to managers deferring acquisitions as a result of the pandemic. The operational infrastructure element of the secured income portfolio has not been affected to the same extent as the long-lease property assets and the Fund's entire commitment of £94m to the underlying manager has been called following the acquisition of a renewable energy plant.

6.3 **Revised Strategic Benchmark:** Following the conclusion of the 2019/20 investment strategy and the resultant asset allocation changes, Officers have been working with Mercer and the Fund's Custodian to revise the strategic benchmark. To date the Fund's Custodian has not been able to factor the Fund's currency overlay programme into the strategic benchmark, which means aggregate level reporting is presented both including and excluding currency hedging in order to highlight the impact of the currency hedge and show performance relative to a like-for-like benchmark. Separately, the return from the LDI mandate, up until this point, has been manually added back into the strategic benchmark by Mercer. Due to the highly customised nature of the LDI mandate the Custodian has historically been unable to source an accurate proxy for the strategy and going forwards will use the change in the NAV as we seek to simplify the performance reporting process and ensure the greatest degree of consistency between the Fund's asset allocation and the strategic benchmark. These changes have been agreed and will be adopted from 3Q20. Officers and Mercer continue to work with the Custodian to explore options for integrating the Fund's FX overlay programme into the strategic benchmark in a cost-efficient manner.

## 7 PORTFOLIO REBALANCING AND CASH MANAGEMENT

### Portfolio Rebalancing

7.1 During the period the Fund redeemed £30m from Multi Asset Credit to bring the allocation further in line with its long-term 6% target. The revised strategic benchmark will take effect from next quarter.

### Cash Management

7.2 Cash is held by the managers at their discretion within their investment guidelines, and internally to meet working requirements. The officers closely monitor the management of the Fund's cash held by the managers and custodian with a particular emphasis on the security of the cash.

7.3 Management of the cash held internally by the Fund to meet working requirements is delegated to the Council's Treasury Management Team. The monies are invested separately from the Council's monies.

7.4 The Fund received a net cash inflow of c£70m in future service and deficit prepayments.

## 8 RESPONSIBLE INVESTMENT ACTIVITY

8.1 **Brunel Responsible Investment Activity:** Key RI achievements over the quarter included:

i. Brunel published their first Responsible Investment and Stewardship Outcomes Report, which evidences policy commitments on ESG risk integration, engagement and stewardship activities. The report seeks to meet the requirements of the new Financial Reporting Standards – Stewardship Code 2020 as well as the EU Shareholder Rights Directive and has been critical in forming the framework for our own Responsible Investment Annual Report.

ii. The shareholder resolution that Brunel co-filed with ShareAction requesting that Barclays publish a plan to phase out the provision of financial services to non-Paris aligned oil and gas companies led to the company publicly stating an ambition to become net zero by 2050. The shareholder resolution itself won significant minority support (24%), exceeding the 20% threshold that requires the bank to consult with shareholders and explain the views received and actions taken publicly within six months.

iii. Human capital, a priority theme for the Fund, was the subject of two new engagement initiatives targeting workplace mental health and modern-day slavery. Specifically, Brunel joined investors representing $2.2tn in co-signing letters to FTSE100 companies asking that formal mental health workplans are established during the period of disruption brought about by the pandemic. Secondly, the Find it, Fix it, Prevent it campaign backed by the Principles for Responsible Investment, undertakes engagement with an aim to push for better public policy to facilitate effective corporate action on modern day slavery, to promote better processes for addressing slavery across supply chains and to develop better data for investors to act on modern day slavery. The initiative has so far received the backing of investors representing £3.5tn.

iv. Finally, Brunel released their annual Carbon Metrics report which revealed that Brunel listed equity portfolios in aggregate are 15.4% more efficient in terms of carbon intensity than the broader market; Brunel's work on climate

change has been recognised as they were named 'Pension Fund of the Year' at the recent Environmental Finance Sustainable Investments Awards.

8.2 **Brunel Engagement Summary**: Federated Hermes engaged with 425 companies held by Avon in the Brunel segregated portfolios on a range of 1,135 ESG issues. Environmental topics featured in 16.7% of engagements, 80% of which related directly to climate change. Social topics featured in 14.7% of engagements, where human capital, human rights and diversity featured prominently. Of the 51.1% of Governance related engagements most focussed on executive remuneration and board diversity. Over the last quarter Hermes made voting recommendations at 394 meetings (5,622 resolutions). At 232 meetings they recommended opposing one or more resolutions. Over 60% of the issues Hermes voted against management on comprised board structure and remuneration.

8.3 **Stewardship Update:** During the quarter, the Fund's external managers undertook the following voting activity on behalf of the Fund:

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| Companies Meetings Voted: | 2618 |
| Resolutions voted: | 37801 |
| Votes For: | 32414 |
| Votes Against: | 4627 |
| Abstained: | 75 |
| Withheld* vote: | 685 |

** A withheld vote is essentially the same as a vote to abstain, it reflects a view to vote neither for or against a resolution. Although the use of 'abstain' or 'withheld' reflects the different terms used in different jurisdictions, a 'withheld' vote can often be interpreted as a more explicit vote against management. Both votes may be counted as votes against management, where a minimum threshold of support is required.*

8.4 The Fund is a member of LAPFF, a collaborative body that exists to serve the investment interests of local authority pension funds. In particular, LAPFF seeks to maximise the influence the funds have as shareholders through co-ordinating shareholder activism amongst the pension funds. LAPFF's activity in the quarter is summarised in their quarterly engagement report at Appendix 3.

## 9 RISK MANAGEMENT

9.1 A key risk to the Fund is that the investments fail to generate the returns required to meet the Fund's future liabilities. This risk is managed via the Asset Liability Study which determines the appropriate risk adjusted return profile (or strategic benchmark) for the Fund and through the selection process followed before managers are appointed. This report monitors (i) the strategic policy and funding level in terms of whether the strategy is on course to fund the pension liabilities as required by the funding plan and (ii) the performance of the investment managers. An Investment Panel has been established to consider in greater detail investment performance and related matters and report back to the committee on a regular basis.

## 10 EQUALITIES

10.1 A proportionate equalities impact assessment has been carried out using corporate guidelines and no significant issues have been identified.

## 11 CLIMATE CHANGE

11.1 The Fund is implementing a digital strategy across all its operations and communications with stakeholders to reduce its internal carbon footprint in line with the Council's Climate Change Strategy. The Fund acknowledges the financial risk to its assets from climate change and is addressing this through its strategic asset allocation to Low Carbon Equities and renewable energy opportunities. The strategy is monitored and reviewed by the Committee.

## 12 OTHER OPTIONS CONSIDERED

12.1 None.

## 13 CONSULTATION

13.1 The Council's Monitoring Officer and Section 151 Officer have had the opportunity to input to this report and have cleared it for publication.

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| **Background papers** | Data supplied by Mercer & SSBT Performance Services |
| **Please contact the report author if you need to access this report in an alternative format** | |